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COMMERCE FOR ITA/MAC/EUR MIKE ROGERS
TREASURY FOR OASIA ANNE ALIKONIS

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SUBJECT: CZECH REPUBLIC: TRADE POLICY AND TRENDS AFTER EU ACCESSION

REF: A. PRAGUE 1325

¶B. PRAGUE 1526

¶1. (U) SUMMARY: As the Czech Republic prepares for the WTO Ministerial Meeting in Hong Kong December 13-18, the Czech economy is basking in rosy statistics (reftel A). The CR is enjoying a trade surplus for the first time since becoming an independent nation in 1993, with 2005 trade surplus forecast at over USD 2 billion (1.7 percent of GDP) after a deficit of USD 1 billion in 2004. Despite the record trade surplus, there are winners (auto and steel) as well as losers (textiles) resulting from both EU accession and globalization. Eighteen months after joining the EU, the country's most significant trading partners remain Germany and the other EU nations. Further EU market penetration remains a GOCR priority, but the government has also been aggressively, if rather haphazardly, pursuing new markets, with an emphasis on China and Russia. Within the EU, the GOCR is learning to maneuver within the "consensus" system by finding regional and subject-specific allies. Non-agriculture market access remains the GOCR,s top priority within the EU and in WTO trade discussions (reftel B). END SUMMARY

GERMANY REMAINS CZECH ECONOMY,S LIFELINE

¶2. (U) As a small open economy, the Czech Republic continues to revolve primarily around the export of three goods: automobiles, electrical machinery, and industrial machinery. The Czech economy can be crudely summarized as a supplier of these goods for final assembly or sale in the Germany economy. Czech exports consist of machinery and transportation equipment (44 percent), intermediate manufacturing products (25 percent), chemicals (7 percent) and raw materials and fuel (7 percent). In the first half of 2005, 84.8 percent of Czech exports went to the EU market. The Czech Republic's largest export partners are Germany with 36 percent and Slovakia with 8 percent. Much of the growth in Czech trade this year can be attributed to the outsourcing of manufacturing from Germany (through direct investment and orders) and the freer flow of goods to traditional partners (such as Poland and Slovakia) following EU accession.

¶3. (U) While further market penetration into the EU remains a government priority, the GOCR is also focused on staying competitive in the face of rising labor costs. Deputy Minister of Trade and Industry Martin Tlapa said that the

government is keenly aware of the problem of eroding comparative advantage. In an attempt to maintain and even increase market share in neighboring countries, he has pushed to improve the efficacy of the national trade promotion agency CzechTrade and ensure that they focus on effective assistance services for Czech exporters. His office has submitted a five year strategy to the cabinet that it hopes will result in a significant increase in Czech exports, especially from SMEs. In discussions with CzechTrade officials, however, it is apparent that no new money is forthcoming to increase staffing in their offices or to expand their current funding levels. They hope that EU funds can be used to support the development of new programs, but the unexpected order earlier this year from the EU to halt one of their SME development programs as "uncompetitive," suggest that EU funds are unrealistic sources for the expansion of trade offices abroad. Prime Minister Paroubek has made it clear that increased trade with Russia and China are goals of his government, but these attempts are at times poorly coordinated (for example, Paroubek neglected to bring anyone from the Ministry of Trade on his visit to China in June 2005). Nevertheless, the Czechs believe that these two markets represent untapped potential for their exports, and look to expand their presence in these countries.

WINNERS: Auto and Steel

¶4. (U) The Czech Republic is one of the largest auto producers in Central and Eastern Europe, and continuing success in the automotive industry is a significant driving force in the economy. 16 percent of the country's exports in the first half of 2005 consisted of road vehicles - the single largest sector in the Czech trade portfolio.

Companies from across the globe (Japan, Germany, Korea, and the United States) continue to invest in the expanding Czech automotive industry. The major player, however, remains Skoda Auto, which is the single largest exporter in the country, accounting for 7.7 percent of the country's entire export value in 2004.

¶5. (U) The Czech steel industry has naturally benefited from the auto-industry boom. Although employment in the industry has declined over the years, productivity is up and companies are profiting from increased domestic demand and exports. However, a dark cloud remains over the industry, which illustrates the inherent weakness of the current economic growth in the country. Necessary structural reforms have not been made which would protect the industry in times of economic downturn. As part of the country's accession, three major producers of steel in the country: Vitkovice, Nova Hut' (now Mittal Steel Ostrava), and Valcovny Plechu (Frydek Mistek) were allotted EU restructuring funds. They have until 2006 to carry out required reforms intended to revitalize and streamline the firms, which were previously sprawling and inefficient relics of the communist era. However, the boom in the market has been too tempting for the companies to miss out on, and instead of reducing production and closing certain mills, as they are required to do under the EU's protocol, they have instead ramped up production. As a result, it appears to be almost certain that the companies will not comply with the protocol. This will cost them billions of Czech crowns in repayments and leaves the companies, in the long-term, subject to the same inefficiencies that will hamper their ability to compete in a normal market.

LOSER: Textiles

¶6. (U) Since 1989, the textile industry has lost over 70 percent of its work force and EU membership has put an end to

the GOCR,s ability to protect the flagging industry. With a dramatically reduced workforce and increased competition from abroad, the textile industry faces a grim future. Chinese imports, according to the Textile Association (ATOK), are the main culprit and with very few exceptions the domestic market is now closed to Czech producers because they cannot compete on price. ATOK and the Ministry of Trade and Industry both pin their hopes on "technical textiles" (defined by the industry as textiles for application where performance and specifications are more important than aesthetics and fashion) as the only hope that can save the domestic textile industry The assumption is that cheap Chinese imports may be hard to compete with on price, but that Czech roducers can find a niche market where they can emain competitive. The recent EU-China spat on txtile quotas was of great interest to the Czech rodducers and they prevailed upon the government o side with other traditional textile-producing cuntries to support continued protection of the EU arket.

ADJUSING TO THE EU "GREAT GAME"

¶7. (SBU) Although several of our Minstry of Trade and Industry contacts lamented the verall weak position that a small country like the Czech Republic has in he EU, they are gradually learning to become savv about working within the "consensus" system. Deputy Minister of Trade and Industry Tlapa said that the tried-and-true Visegrad-4 alliance (Poland, Czech Republic, Slovakia, and Hungary) is oftentimes a good negotiating unit on trade issues. However, trade representatives are learning to find countries with similar interests on a subject-by-subject basis: for example, allying with France and Italy on the latest textile brouhaha with the Chinese. Although they are quick to give the canned response ("trade is a pillar one issue so we stand by the EU position") to any U.S. demarches on trade issues, the GOCR is often eager to hear from US officials that there are other EU nations with whom they may find common ground on issues.

¶8. (SBU) The Head of the Trade Policy Unit at the Czech Mission to the EU Dita Charanzova says that they have learned a lot from the EU internal decision-making process this year, but could only claim "minor victories" (such as pushing for agreements on aluminum) in goading the direction of EU trade

policy, and only with the "very close cooperation with other players".

¶9. (SBU) COMMENT: Even though the Czech economy was a relatively open economy prior to May 2004, EU accession still had a positive impact on the Czech trade balance and helped to boost GDP growth. However, given the country's overwhelming reliance on trade with Germany, diversification is an important future consideration. The importance of trade in non-agricultural goods explains why the country is focused on NAMA in the current WTO negotiations (reftel B). However, the GOCR is unwilling to take on France or neighboring Poland on this issue. While the GOCR is quietly hoping and lobbying within the EU for movement on the agriculture issue, they will ultimately go along with whatever the EU party line is once a decision has been made.
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